Office of Chief Counsel
Internal Revenue Service
memorandum
CC:FIP:B04:JAPolfer

date: 5/12/05

to: Robert C. Harper, Jr.
Manager, EO Technical Group 3
T:EO:RA:T:3

from: Donald J. Drees, Jr.
Acting Chief, Branch 4
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subject: [redacted]
Technical Assistance Request
PRENO-112016-05

This memorandum responds to your request for technical assistance regarding the above company, dated February 23, 2005. You asked us to advise you whether [redacted] qualifies as an "insurance company" as defined under § 1.801-3(a)(1) of the Income Tax Regulations. We conclude, based on the information provided, that [redacted] qualifies as an insurance company for federal income tax purposes for [redacted] and [redacted]. There is insufficient information in the file to make any determination whether [redacted] qualifies as an insurance company after [redacted]

FACTS

[redacted] was incorporated on [redacted] in the [redacted] reinsures, under an excess loss agreement, mortgage guaranty insurance business written on United States risks by [redacted] on mortgages originated by [redacted]. [redacted] is the parent of both [redacted] and [redacted] is not related to [redacted] by ownership or control.

Mortgage guaranty insurance indemnifies lenders against losses incurred as a result of a borrower's default on loans secured by first mortgages on the underlying property. [redacted] is in the business of originating mortgages on single family homes and subsequently selling those mortgages to unrelated investors. [redacted] is initially the insured when a mortgage guaranty insurance policy is issued on a mortgage. When an unrelated buyer purchases the mortgage from [redacted] the insurance policy is irrevocably assigned to the investor.

The reinsurance agreement between [redacted] and [redacted] reinsures an excess layer of risks on loans originated by [redacted] and insured by [redacted] As stated in the [redacted] Agreement,

[redacted]

[redacted] entered into a Trust Agreement, which established a trust fund administered jointly by [redacted] and [redacted] The Trust Agreement requires [redacted] to deposit amounts into the trust equal to established capital and contingency reserve levels. These amounts serve to secure [redacted] performance under the reinsurance agreement.

[redacted] filed an election with the Service under § 953(d) of the Internal Revenue Code to be treated as a domestic organization for federal income tax purposes. For taxable years ending [redacted] and [redacted] net written premium income was $[redacted] and $[redacted] respectively and its investment income was $[redacted] and $[redacted] respectively.

LAW AND ANALYSIS

Section 501(c)(15) recognizes insurance companies or associations other than life (including interinsurers and reciprocal underwriters) as exempt if the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $350,000 for years prior to January 1, 2004. For taxable years beginning after December 31, 2003, the law has been amended stating gross receipts can total $600,000 and premium income must be at least 50% of total gross receipts.

Section 1.801-3(a)(1) defines the term "insurance company" to mean a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business, which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year, which determines whether a company is taxable as an insurance company under the Internal Revenue Code. See Bowers v. Lawyers Mortgage Co., 285 U.S. 182 (1932).

Section 831(c), which applies to taxable years beginning after December 31, 2003, provides that, for purposes of § 831, the term "insurance company" has the meaning given to such term by § 816(a). Under § 816(a), the term "insurance company" means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks

underwritten by insurance companies.

Neither the Code nor the regulations define the term "insurance." The United States Supreme Court, however, has explained that in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. Helvering v. Le Gierse, 312 U.S. 531 (1941). Further, the Court states that "the risk must be an 'insurance risk' as opposed to an 'investment risk'..." Id. at 542. In Allied Fidelity Corp. v. Comm'r, 66 T.C. 1068, 1074 (1976), aff'd 572 F.2d 1190 (7th Cir. 1978), the Tax Court wrote that this risk is a risk of "a direct or indirect economic loss arising from a defined contingency," so that an "essential feature of insurance is the assumption of another's risk of economic loss."

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set-aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums. Clougherty Packing Co. v. Comm'r., 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. See Humana, Inc. v. Comm'r., 881 F.2d 247, 257 (6th Cir. 1989).

The mortgage guaranty insurance written by [redacted] on mortgages originated by [redacted] and subsequently sold to unrelated investors, which became the insureds under the mortgage guaranty insurance policies, is insurance for federal income tax purposes because the risk of borrower's default is shifted from the mortgagee to insurer and is distributed among numerous mortgagees.

For taxable years ending [redacted] and [redacted] net written premium income was $[redacted] and $[redacted] respectively. Thus, for those tax years, FCR satisfied § 501(c)(15)'s requirement for exemption that net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $350,000.

For taxable years ending [redacted] primary and predominant business activity was reinsuring mortgage guaranty insurance business written by [redacted] on mortgages originated by [redacted] and subsequently sold to unrelated investors, which became the insureds under the mortgage guaranty insurance policies. [redacted] primary and predominant business activity during the taxable years ending [redacted] is the reinsuring of risks underwritten by insurance companies, and thus qualifies as an insurance company under § 1.801-3(a)(1). There is insufficient information in the file to make any determination whether [redacted] qualifies as an insurance company after [redacted]

If you have any questions concerning this memorandum, please contact James Polfer, CC:FIP:4, (202) 622-3970.